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Insolvency law: possible future work

Note by the Secretariat

1. At its thirty-eighth session (2005), the Commission had before it a number of proposals (A/CN.9/582 and Add.1-7), on which it heard presentations, for future work in the area of insolvency law, specifically on treatment of corporate groups in insolvency, cross-border insolvency protocols in transnational cases, post-commencement financing in international reorganizations, directors' and officers' responsibilities and liabilities in insolvency and pre-insolvency cases, and commercial fraud and insolvency.

2. After discussion, some preference for the topics of corporate groups, cross-border protocols and post-commencement financing was expressed.[1] The Commission agreed that to facilitate further consideration and obtain the views and benefit from the expertise of international organizations and insolvency experts, an international colloquium should be held, similar to the UNCITRAL/INSOL International/International Bar Association Global Insolvency Colloquium (Vienna, 4-6 December 2000), which had been a key part of the work on the development of the UNCITRAL Legislative Guide on Insolvency Law (see A/CN.9/495). The Commission agreed that in preparing the programme and determining the priorities for a colloquium, to be held in Vienna from 14 to 16 November 2005, the Secretariat should take into account the discussion of the various topics in the Commission.[2]

3. Approximately 95 participants from 36 countries attended the colloquium, including representatives of Governments and international organizations, such as the OECD and the World Bank, and lawyers, accountants, bankers, judges and insolvency practitioners.

4. Based upon the exchange of views and information that took place amongst participants, the present note provides an evaluation and synthesis of the

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Colloquium proceedings and recommendations for possible future work that might be undertaken by the Commission.

I. Treatment of corporate groups in insolvency

5. The Colloquium heard that the business of corporations is increasingly conducted through the medium of a corporate group. A corporate group may be described loosely as a number of separate entity companies that are linked together by some form of common control or ownership, and they are employed in both domestic and international situations. The reasons for the use and popularity such groups are many and varied, ranging from the need for an "organisational" structure to the need to lessen the incidence of taxation. Other reasons include the need for diversification and risk management, the need to establish operating entities in a foreign jurisdiction, the need to facilitate a merger or takeover, and the need to provide for the requirements of a sophisticated financial structure.

6. Corporate groups might conduct their affairs in such a way that some or all of the members of the group may be jointly liable for the external debts of individual members or subject to group guarantees given in respect of the external liabilities of individual members and may transact business between one another that results in internal debts and liabilities between individual members of the group.

7. The structure of a corporate group may be simple or highly complex, particularly if the group is engaged in international trade. A corporate group will be more complex if it has become involved in joint venture arrangements, special purpose corporate vehicles ('SPV'), offshore trusts and partnerships and the like. If this complexity is disturbed by the onset of financial difficulty affecting one or more of the members of a group, problems arise simply because the group is constituted by members that each have a separate legal personality and existence. Absent legislative or judicial intervention, that situation requires that each entity be separately considered and, if necessary, separately administered in insolvency.

8. Considerations relevant to facilitating an understanding of how corporate groups work in practice were identified as including: the accounting treatment of corporate groups; the corporate regulatory requirements concerning corporate groups; the fiscal or taxation motives behind the development of a corporate group; and the sophistication of finance and lending techniques that are employed in relation to groups. Further considerations, relevant to the present treatment of corporate groups in insolvency in a variety of jurisdictions, would include: describing what is meant by a "corporate group" (or similar term); the circumstances under which a case could be commenced in respect of two or more members of a group; and the formal remedies or relief that might be available in respect of insolvent or near insolvent members of a group, for example, procedural consolidation, substantive consolidation, extension of liability, reorganisation involving more than one debtor and miscellaneous remedies (such as dealing with inter-group debts and liabilities, and the application of subordination principles).

9. The Colloquium noted that the topic raised questions of the treatment of corporate groups in insolvency both domestically and internationally in a cross-border context. The view was widely shared that addressing the issue in a cross-border context would be difficult without first considering domestic issues and

achieving a common understanding. The view was also shared that if future work were to be undertaken, care should be taken to ensure that it did not interfere with the high incidence and increasing sophistication of corporate group structures, nor interfere in or create uncertainty with respect to commercial transactions that were entered into with corporate groups (often regardless of the absence or presence of legislation directed at the possible insolvency of or within a group) and also avoid the prospect or possibility of propelling corporate groups toward sanctuary in some foreign "safe haven".

10. The Colloquium heard how different aspects of an insolvency regime were applied to corporate groups in different countries and considered whether provisions might be required to address issues particular to those corporate groups. That discussion identified a number of issues relevant to the treatment of corporate groups, including the following.

(a) In a domestic setting

11. It was noted that because the use and meaning of key terms (e.g. corporate group, control, parent corporation, subsidiary corporation, holding corporation, related or associated corporation) differed between countries, definitions would need to be considered to ensure that a common understanding of the subject matter could be reached. That consideration could also include the extent to which entities other than corporate group members (such as Special Purpose Vehicles, joint ventures, offshore trusts and partnerships and other similar devices) should or may be treated as part of a corporate group.

12. Commencement of insolvency proceedings against a corporate group was discussed and a number of different questions noted, including the applicable test; how that test would be applied to a corporate group (whether to each member of a corporate group or to the group as a whole); whether an application for commencement may be made in respect of more than one debtor; whether a parent (or other member) of a group may apply in respect of every member of the group, including itself); who could apply for commencement (including, for example, commencement by a regulatory body such as a securities or corporate regulatory agency); and how liabilities such as inter-company indebtedness and cross-guarantee liabilities would be treated.

13. Other issues concerning commencement included: the powers (for example, procedural consolidation) that might be given to a court at the time of commencement in respect of some or all of the members of a corporate group; whether the same administrator could be appointed in respect of each group member; how issues of potential conflict (for example, because of cross-guarantees between members of a group, inter-group debts, wrongdoing in respect of one member by another) should be addressed; whether legislation specific to corporate groups might be required in the case of insolvency laws that permitted management to remain in office in insolvency proceedings; and whether special provisions were required with respect to application of a stay or suspension in the case of a corporate group or in respect of post-commencement finance for a corporate group (or two or more of its members).

14. Possible reorganization of a corporate group or members of a corporate group also raised a number of issues including: whether two or more members of a

corporate group could be reorganized through a single reorganisation plan and if so, what special provisions might be required, for example, with respect to the nature and content of a plan; safeguards; convening and conducting creditors meetings in respect of a plan; treatment of creditor claims; voting of creditors; and approval of a plan.

15. Issues relating specifically to corporate groups in insolvency concerned the possible liability of one member of a corporate group (for example, the parent) for the debts and liabilities of an insolvent member of the group and the different approaches that might be taken, including imposing strict liability for all the debts and liabilities of a member of a group, regardless of the circumstances in which they were incurred; imposing liability arising from acquiescence in permitting or directing a member of a group to incur debts when it was or was likely to become insolvent; imposing liability with respect to the conduct of the affairs of the group in such a way that some classes of creditors might be prejudiced (for example, liability to employees of the member); or imposing liability where valid grounds exist for reaching the assets of another member of a corporate group.

16. A further issue of particular relevance to corporate groups and their treatment in insolvency was that of consolidation and whether a domestic insolvency law should provide for consolidating or combining the affairs of two or more members of a group so that there was one pool of assets and one pool of creditors, and the circumstances in which an order for such consolidation might be made.

(b) In an international setting

17. Participants noted the importance of the UNCITRAL Model Law on Cross-Border Insolvency to reorganization of corporate groups in cross-border insolvency cases, in particular the provisions dealing with coordination and cooperation. However, it was also noted that the Model Law did not specifically address a number of other issues relevant to cross-border insolvency of corporate groups, including: how commencement of proceedings could be addressed where the parent or the majority of members of a group were incorporated in one jurisdiction, but other members were incorporated in another jurisdiction or jurisdictions; whether "centre of main interests" in respect of a corporate group and its members needed to be defined in the light of interpretation of that concept in recent cross-border insolvency cases; and the special provisions that might be necessary to ensure the availability of post-commencement finance that involved a corporate group with members in more than one jurisdiction and to foster cooperation between jurisdictions in the case of an international corporate group insolvency. Attention was drawn to the difficulty of reorganizing a corporate group without substantial coordination in a cross-border insolvency case. A further issue was how harmonisation and coordination of international and regional responses to corporate groups and insolvency could be encouraged.

18. On the basis of the discussion at the colloquium, it may be concluded that corporate groups are an increasingly important vehicle for world trade and that the problems being encountered with respect to insolvency of one or more members of corporate groups, both domestically and in an international context, would support further work being undertaken by the Commission. That work might take the form of a text that would provide possible legislative guidance to States wishing to

address issues specific to the treatment of corporate groups in both domestic and cross-border insolvency.

II. Post-commencement financing

19. The colloquium discussed the importance of post-commencement financing to the success or failure of reorganization, particularly with respect to ensuring that the debtor's business could be continued and payments for critical goods and services, supplies, wages, insurance and rent made. Participants noted that there was an emerging consensus on the need to provide statutory authority for the provision of post-commencement finance, as reflected in the treatment of that topic in recent international work on insolvency, including by the International Monetary Fund, the Asian Development Bank, the World Bank, and most recently in the UNCITRAL Legislative Guide on Insolvency Law, which included a chapter of commentary and recommendations on the topic.

20. Participants discussed some of the structural impediments that existed with respect to obtaining such financing in domestic insolvency cases. These included: lack of statutory authority; personal liability of an insolvency representative or directors and officers of the debtor for incurring the debt that such financing would entail; application of avoidance provisions; problems associated with providing priority to post-commencement finance; and a preference for liquidation over reorganization that made the issue of such finance difficult to address. It was noted that only a handful of insolvency laws authorized post-commencement financing and even fewer provided any type of priority for the repayment of such finance. A note of caution was sounded with respect to the relevance of a regime to facilitate post-commencement finance in developing countries where the necessary types of finance might not available.

21. Participants heard about recent national legislative developments with respect to some of these issues and noted that changes were being effected, although slowly.

22. A number of cross-border insolvency cases were discussed and the difficulties with respect to financing, particularly where corporate groups were involved, were evident. Differences existed with respect to the priority accorded to post-commencement finance in different jurisdictions, as well as with respect to providing security for post-commencement finance. There were questions of applicable law, and of whether post-commencement finance obtained by a debtor could be used by another member of the same corporate group and whether non-debtor members of a corporate group could borrow money post-commencement and permit the debtor to use those funds. Participants underlined the need to provide certainty and predictability for lenders in those situations.

23. Based on the discussion, it may be concluded that while the UNCITRAL Legislative Guide on Insolvency Law addresses some of the issues identified, particularly with respect to authorisation, the issue of post-commencement financing in cross-border insolvency of corporate groups could be further considered, building upon the work in the Legislative Guide, as well as upon the work of UNCITRAL in cross-border insolvency. Initially, that work could form an important component of work that might be undertaken with respect to treatment of

corporate groups in insolvency; any additional aspects of the topic could be considered when that work is completed.

III. Cross-border insolvency protocols and court-to-court communication

24. The colloquium heard reports on instruments that had been developed to facilitate the conduct of cross-border insolvency cases, in particular the IBA Concordat and the American Law Institute/International Insolvency Institute Court-to-Court Communication Guidelines and on the status of adoption of the UNCITRAL Model Law on Cross-Border Insolvency. It was emphasized that the Model Law provides the legislative framework for cooperation and coordination in cross-border insolvency cases and the authority, in article 27(d), for the approval or implementation by courts of agreements concerning the coordination of proceedings. A number of cross-border cases involving the use of such agreement or protocols were presented, with particular attention being paid to the types of issues typically covered; how such protocols could facilitate court-to-court communication and cooperation; and the difficulties that had been encountered with the negotiation and use of protocols. Cases where such protocols were not used, but would have facilitated conduct of the case were also discussed, and examples given of why such tools were not always available. It was noted that language problems could be encountered where protocols were being negotiated between countries from different language groups and that the availability of information on cross-border cases and developments in practice, particularly with respect to coordination and cooperation, was essential to facilitate the development that practice, especially in countries that had not had cross-border cases and therefore had not had occasion to use such protocols.

25. It should be noted that appropriate statutory authorization, such as adoption of the UNCITRAL Model Law and in particular, articles 25-27, is required in order to encourage and facilitate cooperation in cross-border insolvency cases and, in particular, to facilitate the use of cross-border protocols. However, while the Model Law provides that fundamental authorization, it does not provide detail, other than in article 27 and some further discussion in the Guide to Enactment, on the practicalities of how that cooperation could be implemented.

26. On the basis of the discussion, it could be concluded that existing legal and judicial experience with respect to the negotiation, use and content of protocols could usefully be made available in some form to the international legal community. The availability of that experience would build upon, complement and provide further impetus for the enactment of the legislative framework provided by the Model Law, facilitating implementation of the coordination and cooperation authorized by articles 25-27 and the development and use of protocols. Issues to be addressed in that work could include: facilitating and guiding communications among courts (e.g. notice to parties, participation by parties and disclosure of substantive issues to parties) and standards for the substance of a protocol (e.g. control and protection of assets, coordinating disposition of assets, post-commencement finance, priority of claims, filing and classification of claims, distribution to creditors and effecting reorganization). Examples of protocols that had been negotiated could also be made more widely available.

IV. Directors' and officers' responsibilities in insolvency and pre-insolvency

27. The colloquium heard that an increasing number of widely publicized insolvency cases were focussing on issues related to director and officer responsibilities and liabilities and the outcomes of those cases pointed to the lack of certainty and predictability in this area. Reports from international organizations on their work in this area highlighted some of the issues and problems encountered. To date, that work had focussed on providing guidance on issues arising in the context of insolvency, rather than on establishing prescriptive rules. Diversity of national approaches to relevant issues and the complexity of those issues, particularly when considering appropriate responses to different types of companies (e.g. small and medium enterprises as opposed to multinational enterprises), as well as the relevance of law other than insolvency law and the importance of social policy, were amongst the reasons for the adoption of that approach. It was pointed out, for example, that while small and medium enterprises typically were characterized by a family relationship between the owner, directors and management, often involving personal guarantees of financial obligations, that characterization was not true for large public enterprises. Accordingly, the abilities and motivations of directors in various types of enterprise structure would differ, as would the economic factors driving the enterprises, particularly as between different types of markets and economies, making a universal, rule-based approach to issues of responsibility and liability hard to achieve. It was noted that national legislation addressing relevant issues was framed in a domestic context around various social policy issues that would also need to be factored into any discussion of a possible unified approach. It was also noted that the topic raised certain issues that were still controversial in a number of countries and international forums, in particular the extent to which directors should be responsible and accountable to creditors, in addition to shareholders.

28. Based on the discussion, it could be concluded that while guidance might be useful in this area to assist both debtors and creditors with determining what constituted acceptable or unacceptable behaviour in proximity to insolvency, certain issues that might need to be addressed in providing such guidance remain controversial and there are concerns about the maturity of the topic for developing that guidance at this time.

V. Insolvency and commercial fraud

29. The colloquium heard a report on work currently being undertaken by UNCITRAL with respect to identifying the common features of fraudulent schemes, including in the context of insolvency, and on UNCITRAL's participation in a study being undertaken by the United Nations Office of Drugs and Crime (UNODC) on fraud and criminal misuse and falsification of identity, including a component on commercial fraud.

30. It was observed that both of those projects focussed on issues of commercial fraud broadly, particularly on identifying what constituted fraud, detecting its

occurrence and combating fraud, and did not address the aftermath of fraud and its impact in insolvency on the employees, creditors and other parties in interest.

31. The Colloquium heard suggestions for specific considerations in the insolvency context, including the allowance and ranking of penalties; minimization of interference by the criminal authorities with the reorganization process; the classification of claims by defrauded investors; the treatment of claims of creditors assisting in a fraud; treatment of intercompany claims between members of a multinational corporate group when fraud is committed by a debtor that becomes subject to an insolvency proceeding; the rights of an estate administrator to recover assets in connection with commercially fraudulent activities; and the forfeiture of assets of insolvent companies.

32. It was noted that the UNCITRAL Legislative Guide on Insolvency Law did not directly address issues relating to fraud in the context of insolvency, except briefly in the context of subordination of claims and the treatment of penalties and fines, although Working Group V had discussed the question during development of the Legislative Guide. The colloquium acknowledged the relevance of questions of fraud to the administration and outcome of insolvency proceedings. It was noted, however, that the issues identified concerned not only legislative approaches to the treatment of issues of fraud in the insolvency context (whether occurring before or during insolvency and whether addressed in the insolvency law or some other law), but also the activities of regulatory authorities that might impact upon the administration of insolvency.

33. On the basis of the discussion, it could be concluded that the work already being undertaken by UNODC on fraud, including commercial fraud, and by UNCITRAL with respect to commercial fraud, should be reviewed to determine the extent to which issues related to fraud in insolvency matters were to be addressed or could be addressed in that context, before considering possible future work on that topic.

VI. Proposal for future work

34. The Secretariat proposes that:

(a) The treatment of corporate groups in insolvency is now sufficiently developed for the topic to be referred to a working group for consideration. A meeting of Working Group V (Insolvency Law) has tentatively been scheduled for 11-15 December 2006 in Vienna;

(b) Post-commencement financing should initially be considered as a component of work to be undertaken on insolvency of corporate groups; the working group could also consider any proposals for work on additional aspects of this topic;

(c) The topic of cross-border protocols could be put on the agenda of a working group, but the initial work of compiling practical experience with respect to negotiating and using cross-border insolvency protocols could be developed through consultation with judges and insolvency practitioners. A preliminary progress report on that work could be presented to the Commission for further consideration at its next session; and

(d) Work being undertaken by other organizations in relation to the topics of directors' and officers' responsibilities in insolvency and pre-insolvency, and insolvency and commercial fraud should be monitored to facilitate consideration, at some future date, of work that might be undertaken by the Commission.

Notes

[1] *Official Records of the General Assembly, Sixtieth Session, Supplement No. 17* (A/60/17), para. 210

[2] Ibid.